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FM AMEMBASSY ULAANBAATAR
TO RUEHC/SECSTATE WASHDC 2158
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RUEHUL/AMEMBASSY SEOUL 3358
RUEHKO/AMEMBASSY TOKYO 3033
RUEHMO/AMEMBASSY MOSCOW 2250
RUEHOT/AMEMBASSY OTTAWA 0625
RUEHBY/AMEMBASSY CANBERRA 0283
RUEHDBU/AMEMBASSY DUSHANBE
RUEHNT/AMEMBASSY TASHKENT 0074
RUEHTA/AMEMBASSY ASTANA 0036
RUEHEK/AMEMBASSY BISHKEK 0112
RUEHAH/AMEMBASSY ASHGABAT 0070
RUEHML/AMEMBASSY MANILA 1756
RUEHBK/AMEMBASSY BANGKOK 1810
RUEHVK/AMCONSUL VLADIVOSTOK 0286
RUEHSH/AMCONSUL SHENYANG 0521
RHEHAAA/NSC WASHINGTON DC
RUEHLMC/MILLENNIUM CHALLENGE CORP WASHINGTON DC
RUEATRS/DEPT OF TREASURY WASHINGTON DC
RUCPDO/DEPT OF COMMERCE WASHINGTON DC
RUEHC/DEPT OF INTERIOR WASHINGTON DC
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SENSITIVE
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SUBJECT: MONGOLIAN PM'S PLAN TO LOWER GAS PRICES BACKFIRES

SENSITIVE BUT UNCLASSIFIED - NOT FOR INTERNET DISTRIBUTION.

11. (SBU) SUMMARY AND COMMENT: In an effort to bolster his party's prospects in the run-up to June 29 Parliamentary elections, Mongolian Prime Minister Bayar embraced a plan to keep gas prices under control by allowing a Russian oil giant to set up 100 gas stations throughout Mongolia. The plan has backfired, with opposition Democratic Party (DP) MPs, petroleum-industry leaders and many ordinary citizens calling it a sell-out to the Russians. Under the plan, Russian state-owned oil products producer Rosneft would have the right to set up a distribution network along key Mongolian transport corridors, including the east-west Millennium Highway, in exchange for holding down gasoline and diesel prices at some unspecified level for an unspecified time. If this proposal were to be approved, Rosneft, which provides more than 90% of Mongolia's fuel, would not only retain its near-monopoly on supply to Mongolia, but also become a leading distributor. Such a proposal would require Parliament to amend Mongolia's Petroleum Law, which limits foreign participation in the sector. The DP, eager to deny any pre-election success to PM Bayar's Government, which is led by the Mongolian People's Revolutionary Party (MPRP), has adamantly opposed any such amendment, arguing that other approaches are possible and that the proposal threatens Mongolian sovereignty and free markets. Mongolians' fear of Russian domination has trumped the lure of lower gas prices, at least for the moment. END SUMMARY AND COMMENT.

12. (SBU) On May 2, Mongolian Prime Minister S. Bayar submitted to Parliament his Government's plan for stabilizing gas prices, which have skyrocketed in recent months. The plan focused on Russian state-owned petroleum product exporter Rosneft, which supplies more than 90% of Mongolia's gasoline and petroleum product needs. At present, all of these imports come through private distribution companies owned and operated by Mongolian firms. The PM's stated concern was that Rosneft would soon be raising prices by US\$62-89 per metric ton on three types of gasoline and diesel, respectively. These increases would raise Mongolian pump prices from the current

US\$1-1.30 per liter to US\$1.10-1.50 per liter. (Note: Because diesel prices would see the greatest increase, and because most transport and shipping methods - including trains and trucks -- use diesel, these price increases would be amplified in all products that require diesel-based shipping, especially meat, wheat and potatoes from the countryside, exacerbating already troublesome food-related inflation. End Note.)

SOFTENING THE BLOW

13. (SBU) Our GOM sources have made clear that the Bayar Government - a three-party coalition, led by Bayar's MPRP -- feared another hefty price increase for fuel. Such an increase, on top of rising costs for food and other imports, would present a direct threat to the re-election prospects of MPRP Members of Parliament. Following the latest fuel-price hikes by Rosneft, the GOM had attempted to soften the blow for consumers through a combination of subsidies and pressure on Mongolian distributors to absorb price increases. (Note: A source at one of Mongolia's largest fuel-distribution companies told us it had taken a major financial hit by following the GOM's "guidance" to keep prices fixed. The promised GOM subsidies never fully materialized, the source added. End Note.) Eventually, it became too costly for the GOM to continue subsidies, and too costly for the private companies to absorb the cut in profit margin. Consequently, distributors began to pass higher costs on to consumers. The popular outcry apparently prompted Bayar to direct his Minister of Industry and Trade, Narankhuu, to reach some sort deal with Rosneft to bring prices down.

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QUID PRO QUO: CHEAPER GAS FOR DISTRIBUTION SYSTEM

14. (SBU) Rosneft informed the GOM that it would consider lowering the price of its petroleum products exported to Mongolia by an unstated amount for an unspecified period, but only if the GOM let Rosneft build 100 gasoline stations along the North-South road that runs from the Russian to Chinese borders, and along the east-west Millennium Road that bisects Mongolia. (Note: Although there is no firm estimate of the amount of traffic carried on these routes, these are best maintained and most heavily trafficked highways in Mongolia. End Note.) PM Bayar accepted this plan and submitted it to Parliament.

PROPOSAL WOULD REQUIRE AMENDING PETROLEUM LAW

15. (SBU) The Rosneft proposal has to be approved by Parliament because Mongolia's Petroleum Law prevents foreign-owned entities from selling more than 30% of all petroleum products sold in Mongolia, and no more than 10% of the sales volume for any particular petroleum product. In addition, the current law bars petroleum producers, such as Rosneft, from domestic distribution and sales. In light of these prohibitions, the PM argued that unless the law was amended immediately, the GOM would be barred from putting its price reduction plan into immediate effect. (Note: Finance Minister Ulan put a glossy spin on this telling donor reps at the UNDP's monthly meeting on May 15 (septel) that the GOM was thinking about "liberalizing" this and other sectors to encourage competition, improve service and reduce prices. End Note.)

DEMOCRATS: YOU MUST BE JOKING

16. (SBU) The response of the opposition Democrats was immediate and virulently negative. The DP, which has centered its election campaign on refusing to approve any legislation for which the MPRP could claim credit, argued that Rosneft's proposal was nothing more than a campaign trick to lower prices in the run-up to elections. The opposition predicted that Rosneft would raise prices soon after the elections, leaving Mongolia with not only higher prices but the Russians in control of both production and distribution. The DP argued that by ceding these rights to the Russians, the GOM wanted to return the petroleum-distribution sector to government control --

Russian Government control. DP members have proposed a return to subsidies, as well as efforts to build refineries for the relatively small amounts of oil that Mongolia produces (and/or coal to fuel facilities). They have made the case that even if this approach means prices will be high in the short run, Mongolia's independence and market economy must not be imperiled. (Note: The DP uses a similar argument to justify its refusal to support MPRP efforts to amend the Law on Mineral Resources. End Note.)

PUBLIC, INDUSTRY INCREASINGLY UPSET OVER PROPOSAL

17. (SBU) The Mongolian public's response to the Bayar proposal was muted at the beginning but has become increasingly loud and harsh. Initially, petroleum-product importers and their supporters -- including importers of American-brand lubricants made by Cal-Tex and Exxon -- remained publicly quiet, fearing some sort of punitive backlash from the GOM or their Russian fuel suppliers. As our sources explained, the GOM could ban imports, claiming pricing irregularities; impose spurious quality tests and ban imports while testing was done; or simply order customs to delay or stop shipments at the border, if local distributors refused to play ball.

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Privately, the distributors were lobbying furiously. They were joined by several large banks that provided the industry with trade financing in excess of 10-15% of their annual loan turnover. Adding to the chorus of boos were the Mongolian National Chamber of Commerce and Industry, the Employers Federation, and several trade unions, all of which feared that thousands of Mongolian workers would lose jobs to the Russian network.

18. (SBU) But the GOM, adamant that the Rosneft deal must be done, told the distributors to stop complaining and accept what had to come. In response, the local distributors took to the airwaves in protest. On May 12, the CEO of Mongolia's largest petroleum distribution company (an MPRP member) gave a TV interview in which she accused the GOM of attacking Mongolia's business community and putting Mongolia's gasoline supply into Russian hands.

19. (SBU) After the plan was announced, media organizations conducted man-on-the-street interviews to gauge reaction. Many indicated that although they would like to see fuel prices stabilized, they are leery of further Russian involvement in Mongolia's petroleum sector.

Some doubted that the Russians would honor any deal, while others accused the PM of selling out to the Russians.

COMMENT

10. (SBU) Bayar and his MPRP have been harmed by their blundering approach on fuel prices. Clearly, Mongolian fear of Russian domination has trumped the lure of lower gas prices. It remains uncertain to what extent the MPRP will pay at the ballot box for this strategic mistake, but the Democrats will almost surely use every opportunity to raise the issue between now and June 29.

GOLDBECK